Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author:	AR&T Committee	Analyst:	LuAnna Hass	Bill Number:	AB 2979
Related Bills:	See Legislative History	Telephone:	845-7478	Introduced Date:	February 27, 2002
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: Adjust. Of Refundable Credit/Clarify Gov't Code/Electronic Signatures/Frivolous Return Penalty/HRA Technical/Substitute "Math. Or Clerical Error" for "Mathematical Error"

SUMMARY

This bill would:

1. Amend the Government Code to delete an obsolete reference.
2. Give the Franchise Tax Board (FTB) statutory authority both to accept e-signatures for returns and to prescribe procedures for e-signatures for returns.
3. Include "clerical error" in the definition of "mathematical error."
4. Address an administrative problem in the processing of the Child and Dependent Care Credit (CDC).
5. Conform state law to federal law regarding certain penalties.
6. Make nonsubstantive, technical changes to the Senior Citizens Homeowners and Renters Property Tax Assistance Laws (HRA).

Each of these provisions will be discussed separately.

POSITION

Support.

On March 6, 2002, the Franchise Tax Board voted 2-0 to sponsor the language included in this bill.

1. CLARIFY GOVERNMENT CODE/STATE TAX LIENS

PURPOSE OF THE THIS PROVISION

The purpose of this provision is to avoid confusion by correcting a cross-reference in statutes pertaining to state tax liens, which in turn will clarify existing law.

EFFECTIVE/OPERATIVE DATE

This provision would be effective and operative January 1, 2003.

Board Position:			Department Director	Date
X S	NA	NP	Alan Hunter for GHG	04/5/02
SA	O	NAR		
N	OUA	PENDING		

ANALYSIS

FEDERAL/STATE LAW

Federal law imposes a lien for unpaid tax liabilities. The Internal Revenue Service (IRS) determines if any person liable to pay any tax neglects or refuses to pay the demand amount. The IRS may issue a lien upon all property and rights to property, whether real or personal, belonging to that person.

A state tax lien attaches to all property and rights to property, whether real or personal, tangible or intangible, that belongs to the taxpayer and is located in this state.

The Government Code establishes certain rules applicable to liens for unpaid liabilities. The Government Code makes several references to former provisions of the Revenue and Taxation Code (R&TC) that provided FTB with authority to impose liens for unpaid income tax liabilities. These Government Code cross-reference provisions have never been updated to reflect the enactment of SB 3 (Stats. 1993, Ch. 31), which, among other things, renumbered those provisions of the R&TC regarding liens for unpaid taxes. SB 3 (Stats. 1993, Ch. 31) created the Administration of Franchise and Income Tax Laws. The purpose of the act was to ensure consistent treatment of taxpayers under the income tax laws by combining the administrative provisions of the Personal Income Tax Law and the Bank and Corporation Tax Law into a new part of the R&TC.

THIS BILL

This provision would remove an obsolete cross-reference in the statutes pertaining to state tax liens and replace it with the correct cross-reference.

IMPLEMENTATION CONSIDERATIONS

Implementing this provision would not significantly impact the department’s programs and operations.

OTHER STATES’ INFORMATION

Since this provision merely clarifies a cross-reference, an examination of other state laws is not relevant.

FISCAL IMPACT

This provision would not impact the department’s costs.

ECONOMIC IMPACT

This provision would have no impact on the state’s income tax revenues, as it is a clarification of existing law.

2. ELECTRONIC SIGNATURES

PURPOSE OF THE PROVISION

The purpose of this provision is to provide FTB clear statutory authority regarding the acceptance of electronic signatures, or “e-signatures.”

EFFECTIVE/OPERATIVE DATE

This provision would be effective and operative on or after January 1, 2003.

ANALYSIS

FEDERAL/STATE LAW

Federal income tax returns, like California income tax returns, may be filed on paper or electronically.

For both federal and state tax purposes, the written signature on a tax return identifies that return as being prepared by and belonging to that taxpayer. A taxpayer may be subject to criminal prosecution if a return[1] is found to be based on false or fraudulent data provided by that taxpayer. A fundamental element of the criminal prosecution is proof that the taxpayer signed the return under penalty of perjury. Therefore, all returns and other documents contain a penalty of perjury declaration[2] printed on the return or document.

For electronically-filed federal returns and other documents, the Internal Revenue Code (IRC) requires the Secretary of the Treasury to develop procedures for the acceptance of electronic signatures. The IRC also provides the Secretary with the authority to waive the signature requirements or provide alternative methods for a signature (IRC Section 6061(b)(1)). Electronic signatures and alternative methods (e-signatures) are treated as a written signature for purposes of a penalty of perjury declaration. According to the IRS website, taxpayers may use a personal identification number (PIN) to sign an electronically-filed return. According to IRS counsel, however, this e-signature alternative to signing a paper return has not been formally adopted under IRC Section 6061(b). Therefore, these procedures may not be legally sufficient to uphold a penalty of perjury prosecution.

According to IRS counsel, historically IRS has not routinely pursued penalty of perjury prosecutions.

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1 For purposes of this analysis, “return” may include income tax returns, franchise tax returns, or other documents required to be filed under the income and franchise tax laws.

2 A penalty of perjury declaration is a statement signed by the taxpayer under penalty of perjury that the return or other document is, to the best of the taxpayer’s knowledge and belief, true, correct, and complete.

California income tax law and practice differs from federal law in that:

- For electronically filed returns, the taxpayer must sign an electronic-filing declaration, which includes a penalty of perjury declaration. The declaration must be retained by the preparer or taxpayer and furnished to the FTB upon request.
- FTB is not expressly authorized or required to develop procedures for e-signatures or authorized to waive signature requirements for returns.
- FTB routinely pursues penalty of perjury prosecutions.

California also has other laws pertaining to e-signatures, as follows:

- The *Government Code* provides that for any written communication with a public entity that requires a signature, a digital e-signature may be used. The e-signature has the force and the effect of a written signature, but only if the e-signature meets certain criteria and is approved by the Secretary of State.
- The *Civil Code* authorizes parties who agree to conduct electronic transactions, including government affairs, to use an e-signature. However, for an e-signature to satisfy the requirements of a signed "penalty of perjury" declaration, an electronic record of all the pertinent information must be stored electronically.
- The *Sales and Use Tax Law* administered by the Board of Equalization (BOE) authorizes the BOE to authenticate an electronically-filed return or other document. Under BOE's electronic filing procedures, the use of a PIN authenticates the taxpayer and replaces the need for a written signature. According to BOE counsel, however, the PIN authentication does not have the force and effect of a written signature for penalty of perjury purposes.

THIS BILL

This provision would give FTB statutory authority to:

- accept e-signatures for electronically filed returns, and
- prescribe procedures for e-signatures for returns.

IMPLEMENTATION CONSIDERATIONS

Staff has not yet determined what form of e-signature would be best suited for FTB and its customers. Under this provision, when the best form of e-signature is ultimately determined by staff, regulations would be adopted to allow the described e-signature to be treated in the same manner as though written for all purposes, including penalty of perjury. The ensuing regulations would be adopted only once staff feels comfortable that penalty of perjury prosecutions can be supported with the e-signature described in those future regulations. FTB could look at the federal procedures to see if they fit California's business needs. FTB would readily adopt the federal procedures if they were appropriate for California's purposes and the procedures have been formally adopted under the IRC Section 6061(b) authority.

If the above does not apply, however, FTB would prescribe regulations setting forth FTB's criteria for an e-signature. These regulations would either:

- describe the federal procedures, in the event those procedures were not formally adopted;
- describe modifications to the formally-adopted federal procedures; or
- prescribe FTB's own independent procedures.

OTHER STATES' INFORMATION

A review of eight states that allow electronic filing of personal income tax returns was made: *Arkansas, Colorado, Illinois, Louisiana, Maine, Massachusetts, Michigan, and New York.* All of these states generally use the electronic-filing declaration containing a written signature, comparable to FTB's current law. *Colorado*, however, does allow for the use of a PIN for direct on-line filing. *Michigan* allows usage of the federal PIN if filing through the IRS' federal/state electronic filing program. Whether prosecutions have been attempted, convictions obtained, and appeals of convictions sustained, in these states in penalty of perjury cases based on these e-signatures is unknown.

FISCAL IMPACT

This provision would not significantly impact the department's costs.

ECONOMIC IMPACT

This provision would not impact the state's income tax revenue.

3. SUBSTITUTE "MATHEMATICAL OR CLERICAL ERROR" FOR "MATHEMATICAL ERROR"

PURPOSE OF THE PROVISION

The purpose of this provision is to codify existing departmental interpretation and practice and to substantially conform to federal law with respect to "mathematical or clerical errors."

EFFECTIVE/OPERATIVE DATE

This provision would be effective January 1, 2003, and would apply without regard to taxable year.

ANALYSIS

FEDERAL/STATE LAW

When a taxpayer submits a federal income tax return to the IRS, the return is checked for clerical errors and for mathematical errors by computing the tax using the figures on the tax return.

The IRC defines "mathematical or clerical error" as:

- an error in addition, subtraction, multiplication, or division shown on any return;
- an incorrect use of any table provided by the IRS if the incorrect use is apparent from other information on the return;
- an entry on a return of an item that is inconsistent with another entry on the return;
- an omission of information that is required to be supplied on the return to substantiate an entry on the return;

- an entry of a deduction or credit amount that exceeds the statutory limit if the amount is expressed as a specified monetary amount or a percentage, ratio, or fraction; and
- an omission of a correct taxpayer identification number (TIN) relating to:

  1. the earned income credit;
  2. self-employment tax;
  3. the child and dependent care credit;
  4. personal exemptions;
  5. the higher education tax credit; and
  6. the child tax credit.

If the preliminary review shows that a return contains a mathematical or clerical error that results in an underpayment of tax, the IRS issues a corrected computation and a notice and demand for payment of any balance due. A tax assessment notice is made on the basis of what would have been the correct amount of tax but for the mathematical or clerical error. Since the error is not considered a deficiency, the taxpayer is not entitled to petition the Tax Court based on the notice. However, a taxpayer may request abatement of the assessment within 60 days after the notice is sent. Upon receipt of the request, the IRS must abate the assessment. If the IRS still believes an assessment is appropriate, it reassesses the amount due and that assessment is then treated as a deficiency.

In 1976, the phrase “mathematical or clerical error” was substituted for “mathematical error” in the IRC. This change was effective for tax returns filed after December 31, 1976. It is unclear, however, if the language regarding general omissions was a part of the definition prior to 1976.

Under state law, much like federal law, state tax returns are reviewed for errors. If an error is found that results in an underpayment of tax, a Return Information Notice (RIN) is issued.

THIS BILL

This provision would substantially conform California law to federal law with respect to the treatment of “clerical errors.” This bill would define mathematical and clerical error to include:

- an error in addition, subtraction, multiplication, or division on any return
- use of an incorrect table
- inconsistent entry of the information
- omission of information
- entry exceeding statutory limit

IMPLEMENTATION CONSIDERATIONS

Implementation of this provision would occur during the department’s normal annual update and would assist the department by ensuring that the meaning of the law is clear.

OTHER STATES’ INFORMATION

Review was made of the laws for *New York, Minnesota*, *Illinois,* and *Massachusetts.* These states were reviewed because of the similarities between California income tax laws and their tax laws. No laws directly on point were found for New York and Minnesota.

Illinois specifically defines a “mathematical error” as including arithmetic errors, incorrect computations on the return or supporting schedules; entries on the wrong lines; omissions of required supporting forms or schedules, or information required on the forms or schedules in whole or part; and an attempt to claim, exclude, deduct, or improperly report an item of income, exemption, deduction, or credit. To challenge a mathematical error assessment, the taxpayer must file an amended return to claim a refund for the tax paid “under protest.” Upon denial of the refund claim by the department of revenue, the taxpayer may protest the denial of the claim in an administrative hearing. Information discussing further abatement provisions in the event of a “mathematical error” was not available.

Massachusetts, in the case of an “arithmetic or clerical error or other obvious error on the face of the return,” allows the commissioner to assess a deficiency attributable to such error without giving notice to the taxpayer of his or her intention to assess the person. The phrase is not further defined.

FISCAL IMPACT

This provision would not impact departmental costs.

ECONOMIC IMPACT

This provision would not impact state income tax revenue.

4. ADJUSTMENT OF A REFUNDABLE CREDIT

PURPOSE OF THE PROVISION

The purpose of this provision is to make the law consistent with the department's process for resolving Child and Dependent Care (CDC) adjustments by providing an informal and simple process for the taxpayer.

EFFECTIVE/OPERATIVE DATE

This provision would be effective January 1, 2003, and operative for all refund claims on the CDC filed after this date.

ANALYSIS

FEDERAL/STATE LAW

Under current federal and state law, the IRS and FTB are responsible for examining income tax returns and ensuring that the correct amount of tax is paid. Current federal and state laws establish various procedures for IRS and FTB to assess taxpayers and for taxpayers to request that the assessment be re-examined. Depending on the nature of the assessment, taxpayers can resolve the assessment either informally (i.e. calling FTB’s Taxpayer Services Center Section) or formally (i.e. a written protest in response to an audit). In addition, for assessments, the deadlines for FTB and taxpayer action differ, and the taxpayer may have the right to challenge an assessment at the Board of Equalization (BOE) or in Superior Court.

Existing federal and state law allows a tax credit based on the expenses incurred by a taxpayer for employment-related child and dependent care. The federal credit is known as the Child and Dependent Care Expenses Credit and is not refundable. The state credit, called the CDC, is refundable and is based on a percentage of the federal Child and Dependent Care Expenses Credit.

THIS BILL

This provision clarifies that the adjustment of refundable credits is to be treated as a claim for refund.

This provision also provides that refundable tax credits in excess of tax liability are an overpayment.

IMPLEMENTATION CONSIDERATIONS

Implementing this provision would improve the department's ability to administer the law relating to adjustments of refundable credits. For example,this provision would clarify that taxpayers can resolve CDC errors, and errors for any refundable credits the Legislature may enact in the future, directly with FTB, rather than having to go directly through the formal Board of Equalization (BOE) appeal process. This provision would assist taxpayers by simplifying the formality of the process and extending the normal statute of limitations time frame for requesting a credit or refund.

TECHNICAL CONSIDERATION

Amendment 1 is provided to correct a grammatical error.

LEGISLATIVE HISTORY

SB 2170 (Senate Revenue and Taxation Committee, Stats. 2000, Ch. 647,) allows adjustments made by FTB to the amount claimed by a taxpayer under the refundable CDC law to be treated by FTB as a mathematical error correction, but the taxpayer is still allowed the right to protest and appeal FTB's adjustment.

OTHER STATES' INFORMATION

Since this provision clarifies a protest procedure unique to California for one particular credit, an examination of other state laws is not relevant.

FISCAL IMPACT

This provision would not significantly impact the department's costs.

ECONOMIC IMPACT

This provision would not impact the state's income tax revenue.

ARGUMENT/POLICY CONSIDERATION

The statute that provides the administrative means for a taxpayer to resolve a dispute or error regarding the CDC credit was erroneously drafted so that the refundable credit is treated like a deficiency rather that like a claim for refund. This bill would permit taxpayer disputes about the amount of CDC to be treated like other refunds, which will reduce the number of appeals filed with BOE and permit taxpayers to resolve their disputes at the lowest level with FTB.

5. FRIVOLOUS RETURN PENALTY

PURPOSE OF THE PROVISION

The purpose of this provision is to conform California law to federal law with respect to the frivolous return, abusive tax shelter, and the aiding and abetting penalties.

EFFECTIVE/OPERATIVE DATE

This provision would take effect January 1, 2003, and apply to returns or lawsuits filed after this date.

ANALYSIS

FEDERAL/STATE LAW

Federal law provides penalties for promoting an abusive tax shelter (the lesser of $1,000 or 100% of the gross income derived from such activity), aiding and abetting the understatement of tax liability ($1,000), and filing a frivolous return ($500).

The taxpayer may pay 15% of the penalty for promoting an abusive tax shelter or aiding and abetting an understatement of tax liability and file a claim for refund. In contrast, the taxpayer must pay the federal $500 frivolous return penalty in full before filing a claim for refund. In cases where a partial payment is permitted, the federal government may counterclaim against the taxpayer for the unpaid amount of the penalty.

State law provides penalties for filing a frivolous return, promoting an abusive tax shelter, or aiding and abetting the understatement of tax liability. The amounts of the described penalties for state purposes are determined in accordance with the federal amounts.

State law is identical to federal law regarding the treatment of the above-described penalties, except as follows:

- State law allows a 15% partial payment for the $500 frivolous return penalty prior to the filing of a claim for refund by the taxpayer.
- State law does not allow a cross-claim for the balance of a partially paid penalty in a court proceeding to determine the taxpayer's liability for that penalty.

THIS BILL

This provision would:

- require taxpayers to pay the entire $500 frivolous return penalty and follow the normal refund litigation process.
- allow California to cross-claim for the balance of the abusive tax shelter penalty or for the penalty for aiding and abetting the understatement of tax, if a taxpayer pays 15% of the penalty and files suit.

IMPLEMENTATION CONSIDERATIONS

Implementing this provision may eliminate some frivolous return litigation cases since the taxpayer would be required to pay the full penalty before filing a lawsuit. As a result, this provision would ease the workload of the department's legal staff and would otherwise not affect the department's programs and operations.

OTHER STATES' INFORMATION

Since this provision proposes changes to the administration of already existing penalties, an examination of other states' tax law is not relevant.

FISCAL IMPACT

This provision may result in some cost savings for the department as a result of a reduced number of frivolous return cases. However, these savings are difficult to quantify.

ECONOMIC IMPACT

This provision would not impact the state's income tax revenue.

ARGUMENTS/POLICY CONCERNS

This provision would conform California law to federal law with respect to the penalties discussed above.

In addition, with respect to the abusive tax shelter penalty and the penalty for aiding and abetting the understatement of tax, the department's ability to cross-claim would eliminate additional litigation to collect the unpaid balance of the penalty.

6. HRA TECHNICAL CHANGE

PURPOSE OF THE PROVISION

The purpose of this provision is to make technical, nonsubstantive changes to the HRA provisions for ease of administration.

EFFECTIVE/OPERATIVE DATE

This provision would be effective and operative January 1, 2003.

ANALYSIS

STATE LAW

State law authorizes FTB to administer several non-tax programs, one of which is the HRA program.

For HRA claimants, existing state law provides partial reimbursement of the previous fiscal year's property taxes on a personal residence paid directly by a homeowner and indirectly by a renter. Relief for homeowners and renters is based on a percentage of the amount of property tax paid in a given year.

To be eligible for assistance, claimants must be 62 years of age, blind, or disabled. In addition, the claimant's total household income for the prior calendar year cannot exceed an inflation-adjusted maximum amount. Also, the gross household income cannot exceed an inflation-adjusted maximum amount.

Claimants may file for assistance from July 1st through October 15th, inclusive. However, FTB may accept claims through June 30th of the year following the year for which assistance is claimed.

THIS BILL

This provision would:

- update various statutory cross-references,
- remove outdated language referencing claims filed for the 1977-1978 fiscal year,
- remove references to prior year gross household income restrictions and insert the 2001 calendar year gross household income figures, and
- change the start of the filing season to June 30.

IMPLEMENTATION CONSIDERATIONS

Implementing this provision would not significantly impact the department's programs and operations.

LEGISLATIVE HISTORY

- SB 1875 (Karnette, 2001/2002) would provide the HRA program with a continuous appropriation and change the documentation requirements for filing an HRA claim. This bill is with the Assembly Rules Committee.
- AB 426 (Cardoza, Stats. 2001, Ch. 156) provided a 45% increase in the income limits for the HRA program.
- AB 440 (Cardoza, Stats. 2001, Ch. 197) provided an additional $75 million appropriation for paying HRA claims for the 2001 calendar year.
- AB 1036 (Pescetti, 2001/2002) would have allowed mobile homeowners that pay real estate property taxes to file a claim for either homeowners or renters assistance. This bill died in the Senate Revenue and Taxation Committee.
- AB 385 (Strickland, 2001/2002) would have increased the homeowners maximum property value, the renters property tax equivalent, and the household income amounts. This bill died in the Assembly Revenue and Taxation Committee.
- SB 218 (Dunn, 2001/2002) and SB 854 (Brulte, 2001/2002) would have provided an increase of 150% for all future claims that are filed beginning with the 2001 claim year. SB 854 failed passage out of the first house (Senate) and SB 218 is in the Assembly Revenue and Taxation Committee.
- SB 1664 (Karnette, Stats. 2000, Ch. 60) provided a one-time 150% increase for claims filed for the 2000 claim year and changed the filing dates to submit claims.

PROGRAM BACKGROUND

The program currently referred to as HRA began in 1968, initially providing relief to senior citizens in the form of property tax assistance. In 1977 the program was extended to renters. Beginning in 1979, totally disabled homeowners and renters, regardless of age, became eligible for assistance under the program.

OTHER STATES' INFORMATION

Information on other states is not relevant, as this provision would make minor technical changes for code maintenance purposes to California statutes.

FISCAL IMPACT

This provision would not significantly impact the department's costs.

ECONOMIC IMPACT

This provision would not impact the state's income tax revenue or HRA assistance payments.

POLICY CONSIDERATIONS

Technically, the HRA statutes are implemented to allow claims to be filed within the intended three and one-half month period and allow the department to accept claims through the end of the fiscal year. The July 1 referred to in the statute is July 1 of the fiscal year that matches the real estate tax year and the state's fiscal year. Therefore, for claims filed in the 2001 calendar year, the July 1 in the statute applies to July 1, 2000, and the October 15 is in the succeeding fiscal year (2001). Consequently, June 30th of the succeeding fiscal year would refer to June 30, 2002.

Although the department is implementing the program according to the technical aspect of the claim period, the explanation of the claim period is convoluted. This provision would change the date to alleviate any confusion for the claimants and the department. The change also would ensure that the program remains, consistent with the long-standing legislative intent underlying the HRA program, a three and one-half month program (or one year with the department accepting claims until the end of the fiscal year) handled within the same calendar year.

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO AB 2979
As Introduced February 27, 2002

AMENDMENT 1

On page 6, line 25, strikeout "Section 17052.6," and insert:

Section 17052.6)